

# ARBITRATION ADVISORY

01-02

## ARBITRATION ADVISORY RE: ENFORCEMENT OF “NON-REFUNDABLE” RETAINER PROVISIONS

May 16, 2001

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### INTRODUCTION

Arbitrators are frequently called upon to evaluate the provisions of a fee agreement that characterizes a payment by the client as “non-refundable” or “earned upon receipt.” There are important differences, however, as to how attorneys are required to treat such payments, depending on the true nature of the payment and regardless of the language used in the fee agreement. Principally, these differences concern (1) the attorney’s obligation, if any, to refund some or all of an advance payment upon discharge or withdrawal and (2) whether the advance payment should be placed in the attorney’s client trust account or in the attorney’s own proprietary account. This advisory will provide guidance to arbitrators in dealing with the enforceability of “non-refundable retainer” provisions in fee agreements and the rules pertaining to the placement of different forms of advance payments.

### OBLIGATION TO REFUND

#### A. Distinction Between “True” Retainers and Other Advance Payments.

Rule 3-700(D)(2) of the Rules of Professional Conduct<sup>1</sup> provides that when the attorney-client relationship has concluded the attorney must:

“Promptly refund any part of a fee paid in advance that has not been earned. This provision is not applicable to a true retainer fee which is paid solely for the purpose of ensuring the availability of the member for the matter.”

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<sup>1</sup> All references to a “Rule” or “Rules” refer to the California Rules of Professional Conduct.

Under Rule 3-700(D)(2), unless the attorney and client have contracted for a “true retainer” (also known as a “classic retainer”), the attorney must refund any portion of an advance fee that the attorney has not yet earned. This raises the question of how to distinguish a “true retainer” from other forms of advance payments. Rule 3-700 (D)(2) itself suggests that a “true retainer” is one that is paid “solely for the purpose of ensuring the availability of the member.” This definition of a “true retainer” was adopted by the California Supreme Court in Baranowski v. State Bar (1979) 24 Cal.3d 153.

In Baranowski, an attorney was disciplined for failing to return advance payments to three clients. The court explained that:

“An advance fee payment as used in this context is to be distinguished from a classic retainer fee arrangement. A [classic] retainer is a sum of money paid by a client to secure an attorney’s availability over a given period of time. Thus, such a fee is earned by the attorney when paid since the attorney is entitled to the money regardless of whether he actually performs any services for the client.” [Id., at 164 fn.4].

It is important to note that the key defining characteristic of a “true” or “classic” retainer is that it is paid solely to secure the availability of the attorney over a given period of time and is not paid for the performance of any other services. In a true retainer situation, if the attorney’s services are eventually needed, those services would be paid for separately, and no part of the retainer would be applied to pay for such services. Thus, if it is contemplated that the attorney will bill against the advance payment for actual services performed, then the advance is not a true retainer because the payment is not made solely to secure the availability of the attorney. Instead, such payments are more properly characterized as either a security deposit or an advance payment of fees for services (see footnote 2, below).

A true retainer is earned upon receipt (and is therefore non-refundable) because it takes the attorney out of the marketplace and precludes him or her from undertaking other legal work (e.g., work that may be in conflict with that client). It also requires that the attorney generally be available for consultation and legal services to the client. Sometimes a true retainer will take the form of a single payment to guarantee the attorney’s future availability for a specified period of time and other times as payments made on a recurring basis, such as a monthly retainer, to assure the attorney’s availability to represent the client for that month. Sometimes this is referred to as having the attorney “on retainer.”

As might be expected, true retainers are rare in today’s legal marketplace. Due to the abundance of competent attorneys in virtually all fields of law, there are probably only a handful of situations in which a client would want to pay a true retainer. Nonetheless, true retainers do have a legitimate, if infrequent, use in the legal

marketplace. As one court has noted, “A lawyer of towering reputation, just by agreeing to represent a client, may cause a threatened lawsuit to vanish.” Bain v. Weiffenbach (Fla.App. 1991) 590 So.2d 544]. In some cases, a client may perceive that only the retained attorney has the requisite skills to handle a particular matter and may want to guarantee that attorney’s availability. In other cases, a true retainer may be used simply to prevent the attorney from representing an adverse party. Other than these examples though, true retainers would seem to be of little use to clients in everyday legal matters.

In other instances, a so-called “retainer” is effectively a security deposit or an advance payment of fees<sup>2</sup>. A payment that represents a security deposit or an advance payment for services to be performed in the future remains the property of the client until earned by the attorney, and any unearned portion is to be returned to the client [Rule 3-700(D)(2); S.E.C. v. Interlink Data Network (9th Cir. 1996) 77 F.3d 1201]. An example of an advance payment for services would be where the attorney charges \$200 per hour and collects a “retainer” of \$2,000, giving the client credit for 10 hours of legal services to be performed in the future. If the attorney is discharged or the matter is otherwise concluded before the attorney has expended 10 hours of his or her time, the attorney must refund the balance of the advance payment that has not yet been earned. Thus, if the attorney had only expended four hours of time prior to being discharged, under Rule 3-700(D)(2) the attorney must promptly refund \$1,200 to the client. In S.E.C. v. Interlink Data Network, *supra*, the law firm’s characterization of the fee as a “present payment for future work,” which it alleged was earned when paid, was unsuccessful in avoiding a refund of the unused portion of the fee to the client’s bankruptcy trustee.

#### B. Language of Fee Agreement Not Controlling.

Advance payments that are not “true” retainers are refundable under Rule 3-700(D)(2) to the extent they are unearned, no matter how the fee agreement characterizes the payment [Matthew v. State Bar (1989) 49 Cal.3d 784; see also Federal Savings & Loan v. Angell, Holmes and Lea (9th Cir. 1988) 838 F.2d 395, 397-398]. In Matthew, two fee agreements provided for a “non-refundable” retainer payment. In each instance it was contemplated that the attorney would bill against the “retainer”, but the attorney failed to fully perform the required services. The attorney was disciplined both for client abandonment and for failure to account for and return the unearned portion of the fees. Thus, the attorney’s characterization of the retainer as “non-refundable” in the fee agreement did not abrogate the attorney’s duty to return any portion of the fee that had not been earned. The Supreme Court emphasized that “Retention of unearned fees [is] serious misconduct warranting periods of actual suspension, and in cases of habitual misconduct, disbarment.” [*Id.* at 791]. A member’s failure to promptly account for and return the unearned portion of an advance fee

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<sup>2</sup> An “advance payment” would typically be applied toward the client’s bill at the end of the current billing period. A “security deposit” is one held by the lawyer throughout the representation and refunded to the client once all services are completed and the attorney has been paid. For convenience, a security deposit is sometimes applied to the final invoice.

warrants discipline [In the Matter of Fonte (Review Dept. 1994) 2 Cal. State Bar Ct. Rptr. 752].

Another case in which the language of the fee agreement did not control the characterization of the advance payment is In re: Matter of Lais (1998) 3 Cal. State Bar Ct. Rptr. 907. In the Lais case the attorney's fee agreement read as follows:

"Client agrees to pay attorney for his services a fixed, non-refundable retainer fee of \$2,750 and a sum equal to \$275 per hour after the first ten hours of work. This fixed, nonrefundable retainer is paid to the attorney for the purpose of assuring his availability in the matter."

Even though the language of the agreement stated that the advance was being paid to assure the attorney's availability and was nonrefundable, the advance was clearly also to be applied to the first ten hours of work. Therefore, the advance was not paid solely to assure the attorney's availability. The court held that the \$2,750 payment was not a true retainer and that the attorney was required to refund any amount that had not been earned.

### C. Unconscionability

Civil Code section 1670.5 provides that a contract may be found to be unenforceable if its terms are unconscionable. In addition, Rule 4-200 of the Rules of Professional Conduct provides that an attorney may not charge or collect an illegal or unconscionable fee. In some cases, a payment that is properly characterized as a true retainer may nonetheless be unenforceable if it is found to be unconscionable.

The concept of unconscionability has both procedural and substantive elements [Samura v. Kaiser Foundation Health Plan, Inc. (1993) 17 Cal.App.4<sup>th</sup> 1284, 1296]. Substantive unconscionability refers to the harshness of the contract terms. "Substantive unconscionability is indicated by contract terms so one-sided as to shock the conscience." [American Software, Inc. v. Ali (46 Cal.App.4<sup>th</sup> 1386, 1391; see also Bushman v. State Bar (1974) 11 Cal.3d 558, 563-566 (attorney's fee found unconscionable where it was "so exorbitant and wholly disproportionate to the services performed as to shock the conscience.")).]. Procedural unconscionability refers to the manner in which the contract was negotiated and the circumstances of the parties at that time [Kinney v. United HealthCare Services, Inc. (1999) 70 Cal.App.4<sup>th</sup> 1322, 1329]. Examples of issues relevant to a procedural unconscionability analysis are the inequality in bargaining power between the parties and the absence of real negotiation or meaningful choice [American Software Inc. v. Ali (1996) 46 Cal.App.4<sup>th</sup> 1386, 1391].

Presumably, both substantive and procedural unconscionability must be present before a contract will be held unenforceable. However, a relatively larger degree of one will compensate for a relatively smaller degree of the other [Samura v. Kaiser Foundation Health Plan, Inc. (1993) 17 Cal.App.4<sup>th</sup> 1284, 1296-1297]. Stated another

way, “a compelling showing of substantive unconscionability may overcome a weaker showing of procedural unconscionability.” [Carboni v. Arrospide (1991) 2 Cal.App.4<sup>th</sup> 76, 86].

Rule 4-200 sets forth eleven factors to be examined in determining whether an attorney's fee is unconscionable. Some of these factors include: (1) the relative sophistication of the attorney and the client; (2) the amount of the fee in proportion to the value of the services rendered; and (3) the experience, reputation and ability of the attorney. One case held that a fee agreement requiring the client to pay a “minimum fee” upon discharge was unconscionable [In re: Scapa & Brown (1993) 2 Cal. State Bar Ct. Rptr. 635, 652].

Unconscionability in the context of a true retainer agreement would normally not be a consideration where the client is a sophisticated purchaser of legal services, a large insurance company or a corporation for example, or where the attorney's skill and reputation are well known. As previously noted, however, the situations in which a client may have a valid reason for paying a true retainer fee are not very common. True retainers should therefore be scrutinized to see if the fee is unconscionable. For example, a client may receive very little or no value at all by ensuring the availability of the attorney if the attorney has no particular reputation or expertise and if there is an abundance of other competent attorneys available to handle the client's matter. In cases such as this, a true retainer might be unconscionable, particularly if the amount charged is very high and the client is not a sophisticated purchaser of legal services.

In examining whether a true retainer withstands an unconscionability analysis, it is important to remember that an agreement may only be avoided on grounds of unconscionability based on the facts as they existed at the time the contract was formed [Civil Code section 1670.5; Rule 4-200(B)]. “The critical juncture for determining whether a contract is unconscionable is the moment when it is entered into by both parties, not whether it is unconscionable in light of subsequent events.” [American Software Inc. v. Ali (1996) 46 Cal.App.4<sup>th</sup> 1386, 1391].

Thus, if a client enters into a true retainer agreement with a famous criminal defense attorney because the client fears that he will be indicted and wants to ensure the defense attorney's availability, the client could not avoid the contract on grounds of unconscionability merely because the indictment never occurred. On the other hand, if the same client entered into a true retainer agreement with an attorney who had no experience or reputation in handling criminal law matters, the retainer might be unconscionable depending upon the amount paid and the sophistication and bargaining power of the client, regardless of whether the indictment occurred or not.

## **PLACEMENT OF ADVANCE FEES AND TRUE RETAINERS**

The issue of where attorneys should place advance payments depends on the nature of the payment. Rule 4-100 provides, in pertinent part:

“All funds received or held for the benefit of clients by a member or law firm, including advances for costs and expenses, shall be deposited in one or more identifiable bank accounts labeled "Trust Account", "Client Funds Account" or words of similar import.....No funds belonging to the member or the law firm shall be deposited therein or otherwise commingled ”

Because true retainers are earned upon receipt, they are not “funds held for the benefit of the client.” Therefore, Rule 4-100’s prohibition on commingling “funds belonging to the member” means that true retainers should be placed in the attorney’s proprietary account and not in the client trust account.

Two courts since Baranowski [Baranowski v. State Bar, *supra*] have declared that it is undecided in California whether, under Rule 4-100, an advance payment for services or a security deposit must be deposited into the client trust account [SEC v. Interlink Data Network (9th Cir. 1996) 77 F.3d 1201, n.5; Katz v. Worker’s Comp. Appeals Bd. (1981) 30 Cal.3d 353, n.2]. Yet, in T & R Foods, Inc. v. Rose (1996) 47 Cal.App.4th Supp. 1, the Appellate Department of the Los Angeles County Superior Court held that under Rule 4-100 an advance fee must be deposited into an attorney’s trust account, and that an attorney’s failure to segregate the advance fee or security deposit from his general funds constituted a breach of fiduciary duties<sup>3</sup>. The T&R court reasoned that the language of 4-100 indicated “an intent by the State Bar that funds retain an ownership identity with the client until earned.” [*Id.*, at 7].

Importantly, the T&R opinion noted that attorneys who commingle advance fees or security deposits with their own funds are not only subject to discipline by the State Bar, but also subject to civil liability for professional negligence and breach of fiduciary duty. Although the T&R opinion may not be binding on California’s appellate courts, it is currently the only opinion that decides the issue one way or the other. Therefore, unless a higher court disapproves the T&R opinion, an event that is by no means certain, California attorneys are required to follow its’ holding.

## CONCLUSION

In the context of a fee arbitration, when presented with circumstances where the client has made an advance payment and claims entitlement to a refund of all or a portion of the advance, arbitrators should carefully consider the following issues:

- (1) Whether the retainer is a “true retainer” or a “classic retainer” that was paid solely to ensure the attorney’s availability and not paid for the performance of any particular legal services;

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<sup>3</sup> Note that all advances for *costs and expenses* must be placed in a client trust account because they are funds held for the benefit of the client [Stevens v. State Bar (1990) 51 Cal.3d 283].

- (2) Whether the retainer merely represents an advance payment or security deposit for actual legal services to be performed in the future. A provision that the attorney will charge an hourly rate to be billed against the retainer is a conclusive indicator that the payment is an advance payment or a security deposit that is refundable unless fully earned;
- (3) If the payment represents a true retainer fee paid solely to ensure the availability of the attorney, whether the fee is unconscionable in light of the facts as they existed at the time the agreement was formed; and
- (4) To the extent it may bear upon the fees, costs, or both to which the attorney is entitled [See Business & Professions Code section 6203(a)], whether the attorney complied with Rule 4-100(A) in placing the advance payment in the appropriate account.